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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

KRAFT GENERAL FOODS, INC.
(formerly KRAFT, INC.),

Petitioner,

v.

IOWA DEPARTMENT OF REVENUE AND FINANCE,

Respondent.

On Writ of Certiorari to the Supreme Court of Iowa

BRIEF FOR PETITIONER

JEROME B. LIBIN
(Counsel of Record)
KATHRYN L. MOORE
HEATHER C. MALOY

SUTHERLAND, ASBILL & BRENNAN
1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
(202) 383-0100

Counsel for Petitioner

Of Counsel:

JOHN V. DONNELLY

BROWN, WINICK, GRAVES, DONNELLY, BASKERVILLE AND SCHOENEBAUM
1100 Two Ruan Center
601 Locust Street
Des Moines, Iowa 50309
(515) 283-2076

PRESS OF BYRON S. ADAMS, WASHINGTON, D.C. (202) 347-8203

QUESTIONS PRESENTED

1. Whether a state statute can be found to discriminate impermissibly against foreign commerce in violation of the Foreign Commerce Clause without a showing that the discrimination provides a commercial advantage to purely local businesses.

2. Whether the Iowa Business Tax on Corporations, which facially discriminates against foreign commerce by including foreign subsidiary dividends in the Iowa tax base while excluding domestic subsidiary dividends from that base, violates the Foreign Commerce Clause.

3. Whether the Iowa Business Tax on Corporations violates the Equal Protection Clause because its classification of dividend income is not rationally related to a legitimate state purpose.

RULE 29.1 STATEMENT

The parent company of petitioner is Philip Morris Companies, Inc. The subsidiaries of petitioner, other than wholly-owned subsidiaries, are listed in the Appendix to the Brief at pages 1a - 3a.

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On Writ of Certiorari to the Supreme Court of Iowa

BRIEF FOR PETITIONER

OPINIONS BELOW

The opinion of the Supreme Court of Iowa (reproduced in the Appendix to the petition for a writ of certiorari (Pet. App. at 1a-10a)) and the order of the Supreme Court of Iowa denying rehearing (Pet. App. 57a) were reported at 465 N.W.2d 664 (Iowa 1991). The findings of fact, conclusions of law, and judgment of the District Court of Iowa in and for Polk County (Pet. App. 11a-23a) have not been reported. The order of the Iowa Department of Revenue and Finance (Pet. App. 24a-27a) has not been reported.

JURISDICTION

The judgment of the Supreme Court of Iowa was entered on February 20, 1991. Petitioner's timely petition for rehearing was denied on March 19, 1991. (Pet. App. 57a) The petition for a writ of certiorari was filed on June 14, 1991, and was granted on January 21, 1992. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the Constitution, art. I, sec. 8, cl. 3 provides: The Congress shall have power "[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

The Equal Protection Clause of the United States Constitution, amend. XIV, sec. 1, provides that: "No state shall . . . deny to any person within its jurisdiction the equal protection of the laws."

Relevant portions of sections 422.33 and 422.35 of the Iowa Code, Sections 243, 901, 902, 1504, and 7701 of the Internal Revenue Code, and section 1.1502-14(a)(1) of the Federal Income Tax Regulations are set forth in Pet. App. 58a-63a, 64a-70a, and 71a, respectively. Relevant portions of sections 61, 78, and 164 of the Internal Revenue Code and section 422.35 of the Iowa Code are set forth in the Appendix to this Brief ("A"), 3a-11a.

STATEMENT

A. Relevant Facts

Petitioner is a Delaware corporation with its principal office and commercial domicile in Illinois. It is

engaged in the production, processing, and distribution of food and food products. Petitioner conducts a unitary business in Iowa, other states, and various foreign countries.

In 1981, petitioner owned more than 80 percent of the capital stock of six corporations that were part of its unitary business and that conducted their business activities exclusively outside the United States. Those subsidiaries (and their respective countries of incorporation) were Dominion Dairies Ltd. (Canada); Kraft Limited (Canada); Kraft Foods S/A (Denmark); Kraft G.m.b.H.(Germany); Kraft S.p.A. (Italy); and Alimentos Kraft de Venezuela C.A.(Venezuela). (Pet. App. 29a and 52a)

For a variety of reasons, U.S. corporations conducting business abroad typically do so through subsidiary corporations organized in the countries in which they operate. The parties have stipulated that those reasons include, but are not limited to, the requirements of the foreign country, a better ability to limit the company's liability in that country, marketing advantages as customers perceive the subsidiary as a local company, greater ease in repatriating funds, greater ease in borrowing funds in the country of operation, and the ability to own property and to manufacture in that country. (Pet. App. 30a-31a)

During 1981, the six named subsidiaries paid to petitioner, out of the earnings of their foreign operations, aggregate dividends of $10,181,815. The dividends were part of petitioner's unitary business income. (Pet. App. 33a and 53a) Foreign withholding taxes of $1,490,887 were imposed on the dividends by the countries where the foreign subsidiaries operated. (Pet. App. 53a) In addition, the earnings of

the subsidiaries from which the dividends were paid were subjected to foreign income tax by those countries. (Pet. App. 12a)

B. Iowa Taxing Scheme

The Iowa Business Tax on Corporations imposes an income tax on that portion of the "net income" of a corporation that is reasonably attributable to its trade or business carried on within Iowa. The amount of income subject to tax by Iowa is determined by application of the state's allocation and apportionment rules to the corporation's total "net income." (Pet. App. 58a-62a)

Iowa uses federal law as the starting point for calculating its corporate tax base. In 1981, the relevant Iowa statute defined "net income" as "the taxable income . . . properly computed for federal income tax purposes under the Internal Revenue Code", with certain specified adjustments. (Pet. App. 62a)[1]

1. Calculation of Federal "Taxable Income"

Under the federal Internal Revenue Code, dividends from subsidiaries are included in a corporation's "gross income." 26 U.S.C. § 61. In computing federal "taxable income," the Internal Revenue Code allows a corporation to deduct from its gross income a certain percentage of the dividends it has received from "a domestic corporation which is subject to [federal income] taxation." 26 U.S.C. § 243.[2] (This deduction

[1] The current Iowa Code provisions are essentially the same. Iowa Code §§ 422.33, 422.35 (1990 & Supp. 1991).

[2] A "domestic corporation" is defined as a corporation created or organized in the United States or under the law of the United States or of any State. 26 U.S.C. § 7701(a)(4).

is known as the "dividends-received-deduction.") If both the payor and recipient of the dividend are members of an "affiliated group" of domestic corporations, (*e.g.*, if the recipient corporation owns at least 80 percent of the capital stock of the payor), federal law allows a dividends-received-deduction equal to 100 percent of the dividends received. 26 U.S.C. §§ 243, 1504.[3] The 100 percent dividends-received-deduction has the effect of exempting "domestic subsidiary dividends" from federal income tax.[4]

Federal law does not permit a corporation to deduct any portion of the dividends it receives from a foreign subsidiary that conducts its business operations exclusively in a foreign country.[5] "Foreign subsidiary

[3] Dividends eligible for the full 100 percent dividends-received-deduction are referred to herein as "domestic subsidiary dividends."

[4] If the recipient and payor corporations are not members of an affiliated group the amount of the dividends-received-deduction is reduced. In 1981, the reduced deduction equalled 85 percent of the dividends received. 26 U.S.C. § 243. (1976 & Supp. V 1981). Under current law, the deduction is equal to either 80 percent or 70 percent of the dividends received, depending upon the recipient's level of stock ownership in the payor. 26 U.S.C. § 243.

Members of an affiliated group of corporations may elect to file a single consolidated federal income tax return in lieu of separate returns. If a consolidated return is filed, dividends paid by one member to another are "eliminated" from taxable income, producing the same result as a 100 percent dividends-received-deduction. Treas. Reg. § 1.1502-14(a)(1). Only domestic corporations are eligible to file a federal consolidated return. 26 U.S.C. § 1504(b).

[5] Dividends received from a foreign subsidiary that is at least 80 percent-owned by its U.S. parent and that conducts its busi-

dividends" are thus fully includible in federal taxable income.[6]

Federal law excludes "domestic subsidiary dividends" from taxable income because they are paid from income that itself is subject to U.S. tax as earned by the domestic subsidiary. The dividends-received-deduction is designed to avoid federal double taxation of corporate earnings while they remain in corporate solution.

Federal law includes "foreign subsidiary dividends" in taxable income because the underlying earnings of the foreign subsidiary are not subject to U.S. tax. To mitigate the consequences of international double taxation, the Internal Revenue Code allows a recipient of foreign subsidiary dividends a credit against its U.S. tax liability for foreign taxes withheld from the dividends and for foreign taxes paid by the subsidiary on the income from which the dividends were paid.[7]

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ness entirely outside the United States are referred to herein as "foreign subsidiary dividends."

[6] The Internal Revenue Code allows a deduction for dividends received from a foreign subsidiary that carries on business in the United States. 26 U.S.C. § 245. The amount of the deduction generally reflects the extent of the foreign subsidiary's U.S. business activity.

[7] If a parent corporation claims a foreign tax credit with respect to foreign subsidiary dividends, it is required to include in its income (as an additional "dividend") the amount of foreign income taxes paid by the subsidiary on the earnings from which the dividends were paid. 26 U.S.C. § 78. That inclusion is known as the "gross-up" amount.

As an alternative to the foreign tax credit, the Internal Revenue Code allows a deduction for foreign withholding taxes imposed. 26 U.S.C. § 164 (allowing a deduction for state, local,

Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶¶ 5.05 and 17.11 (5th ed. 1987).

2. Calculation of Iowa "Net Income"

As noted, Iowa adopts federal "taxable income" as the starting point for determining the corporate "net income" that it subjects to tax after apportionment. As a result, a corporation doing business in Iowa calculates its Iowa tax base with (1) "domestic subsidiary dividends" fully excluded, by virtue of the 100 percent federal dividends-received-deduction, and (2) "foreign subsidiary dividends" fully included, by virtue of the absence of a federal deduction with respect to such dividends.

Iowa does not adopt all provisions of the Internal Revenue Code, however. For example, it does not allow a credit against Iowa tax liability for foreign taxes incurred with respect to a foreign subsidiary dividend.[8]

As illustrated by Exhibits 4 and 5 to the Stipulation below (Pet. App. 55a-56a), Iowa's taxing scheme exposes a corporation receiving a $100,000 foreign subsidiary dividend to a tax burden to which an otherwise similarly situated corporation receiving a $100,000 domestic subsidiary dividend is not exposed. The result is the imposition of a discriminatory income tax on

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and foreign income taxes paid or incurred). A credit against tax liability is generally more valuable to a taxpayer than a deduction.

[8] If the taxpayer has claimed a foreign tax credit for federal purposes, Iowa excludes the "gross-up" amount from the computation of the taxpayer's "net income" for Iowa tax purposes. (Pet. App. 56a) (A 4a-5a)

any corporation operating in Iowa whose unitary business income includes dividends from subsidiaries organized and operating in foreign countries.

C. Similar State Taxing Schemes

In addition to Iowa, 40 states currently utilize federal taxable income as the starting point for calculating net income subject to corporate income tax.[9] Ten of those states adopt the federal tax distinction between foreign and domestic subsidiary dividends.[10] Three of the ten states discriminate in identical fash-

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[9] Five states with a corporate income tax (Alabama, Arkansas, California, Mississippi, and Utah) plus the District of Columbia do not utilize federal taxable income as the starting point in their calculations. Four other states (Nevada, South Dakota, Washington, and Wyoming) do not impose a corporate income tax. See Pet. App. 73a-75a for all state statutory citations except Texas and Pennsylvania, which are contained herein at nn. 11, 12, *infra*, respectively.

[10] Fifteen of the 40 states exclude both domestic and foreign subsidiary dividends from their tax base calculation. Arizona, Connecticut, Delaware, Florida, Georgia, Illinois, Indiana, Kentucky, Maryland, Michigan, Nebraska, Ohio, Texas (1991 Tex. Sess. Law. Serv. 1st C. Sess. Ch.5 (H.B. 11) § 171.110 (Vernon), effective for taxable years beginning on or after January 1, 1992; Texas previously did not impose a corporate income tax), Virginia, and West Virginia.

Eleven states include both types of dividends in the calculation. Hawaii, Louisiana, Massachusetts, Minnesota, New Jersey, New York, North Carolina, North Dakota, Oregon, Tennessee, and Wisconsin.

Four states (Alaska, Idaho, Montana, and New Hampshire) that utilize federal taxable income have adopted variations on the federal law that make comparisons inappropriate.

ion with Iowa,[11] and seven do so with certain modifications.[12] Two other jurisdictions that do not follow the federal scheme discriminate in a manner similar to Iowa.[13]

D. Proceedings Below

In calculating its federal taxable income for the taxable year 1981, petitioner included its foreign subsidiary dividends in income in accordance with applicable federal rules. (Pet. App. 32a) (Petitioner received no domestic subsidiary dividends in that year.) Petitioner also claimed a credit against its federal tax liability for the foreign taxes attributable to its foreign subsidiary dividends. (*Id*)

In calculating its 1981 "net income" for purposes of the Iowa Business Tax on Corporations, petitioner deducted its foreign subsidiary dividends from the amount of federal taxable income it had separately calculated. The Iowa Department of Revenue and Finance ("the Department") assessed additional tax against petitioner on the ground that its foreign subsidiary dividends should have been included in petitioner's Iowa tax base. (Pet. App. 13a-14a)

Before the Department, petitioner challenged the constitutionality of the Iowa taxing statute under the Commerce Clause and the Equal Protection Clause of

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[11] New Mexico, Vermont, and, most recently, Pennsylvania (1991 Pa. Legis. Serv. Act 1991-22 (H.B. 185) § 401(3)(1)(b) (Purdon), as amended on August 4, 1991 and effective for taxable years beginning on or after January 1, 1991; Pennsylvania previously excluded all dividends from corporate taxable income).

[12] Colorado, Kansas, Maine, Missouri, Oklahoma, Rhode Island, and South Carolina.

[13] Alabama and the District of Columbia.

the United States Constitution and on other grounds. The Iowa Director of Revenue declined to render a decision on the ground that he had no authority to decide the "facial constitutionality" of the statute. (Pet. App. 26a)

On review, the District Court of Iowa in and for Polk County ("District Court") held that the statute did not discriminate in violation of the Commerce Clause because it did not benefit "local in-state industry in detriment to out-of-state industry." (Pet. App. 16a-17a) The District Court also held that the tax did not result in multiple taxation in violation of the Commerce Clause, an argument that petitioner did not pursue further. (Pet. App. 18a-22a) Finally, the District Court held that the statute did not violate the Equal Protection Clause because the Department's rationale for using federal taxable income as its starting point—convenience to the taxpayer and the State—was rationally related to a legitimate state purpose. (Pet. App. 23a)

The Supreme Court of Iowa affirmed. After noting that "Supreme Court decisions are unclear whether such a local bias must be found when discrimination against foreign commerce is alleged," the court held that the Iowa taxing scheme did not violate the Commerce Clause because it did not benefit Iowa businesses at the expense of foreign businesses. (Pet. App. 7a-8a) The Iowa Supreme Court also agreed with the District Court that the Equal Protection Clause was not violated because the State's purpose in using federal taxable income as its starting point—taxpayer and administrative convenience—was a legitimate purpose. (Pet. App. 10a)

The total amount of tax assessed against petitioner by respondent for 1981 was approximately $39,000 (Pet. App. 33a), of which approximately $17,000 was attributable to the issue here presented. The outcome of this case will affect taxable years of petitioner from 1978 forward. (Pet. App. 43a)

SUMMARY OF ARGUMENT

The Iowa taxing scheme facially discriminates against foreign commerce by including foreign subsidiary dividends in its corporate tax base while excluding domestic subsidiary dividends from that base. For that reason, it must be struck down without further inquiry.

The Iowa Supreme Court and respondent before this Court have taken the position that the Iowa statute is not impermissibly discriminatory because it confers no particular benefit on Iowa businesses or Iowa activity that is not conferred on other domestic businesses or other domestic activities.

The "local advantage" test adopted by the court below finds its origins in this Court's decisions involving the Interstate Commerce Clause. It has no application to challenges arising under the Foreign Commerce Clause. Prior decisions of this Court dating back to 1878 have established that a state taxing scheme that facially discriminates against foreign commerce will be struck down without requiring a showing of local benefit.

A state taxing statute like Iowa's necessarily interferes with the free flow of foreign commerce in direct contradiction to the purpose and intent of the Foreign Commerce Clause. Insisting upon a showing

of benefit to "local commerce," as was done by the court below, improperly limits the intended reach of that Clause.

This Court's analysis in *New Energy Co.* v. *Limbach*, 486 U.S. 269 (1988), does not validate the Iowa statute. First, that analysis is not applicable here because, unlike *New Energy*, the instant case does not even arguably involve an indirect exercise of police power through a taxing statute. Moreover, the State's asserted purpose of convenience can easily be achieved by a reasonable nondiscriminatory means: subtracting foreign subsidiary dividends from the tax base.

The Iowa statute also deprives petitioner of the equal protection of the laws. Taxpayer and administrative convenience, the only reason offered for the classification of dividend income, is not a legitimate purpose here. Even if it were legitimate, the numerous and complex adjustments to federal taxable income required to compute Iowa net income illustrate that the taxing scheme as a whole is not rationally related to that purpose. Iowa's decision to pick and choose which federal numbers to incorporate in its tax base makes its taxing scheme "wholly arbitrary" as applied to dividend income.

ARGUMENT

I. IOWA'S METHOD OF TAXING DIVIDEND INCOME IMPERMISSIBLY DISCRIMINATES AGAINST FOREIGN COMMERCE.

Despite its power to do so, Congress has not chosen to enact comprehensive legislation designed to regu-

late state taxation of income.[14] Thus, federal law does not require the states to tax dividend income in any particular manner. *Mobil Oil Corp.* v. *Commissioner of Taxes* 445 U.S. 425, 448-449 (1980). The absence of federal regulation does not, however, leave the states free to tax such income in any manner they please. As this Court stated in *Wardair Canada, Inc.* v. *Florida Department of Revenue*, 477 U.S. 1 (1986), where the federal government has not affirmatively acted, "it is the responsibility of the judiciary to determine whether action taken by state or local authorities unduly threatens the values the Commerce Clause was intended to serve." *Id.* at 7.

This Court has developed a six-part test for determining whether a state taxing statute violates the Foreign Commerce Clause. The first four prongs of that test, originally developed in the interstate commerce context in *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274, 279 (1977), ask whether the tax is (1) applied to an activity with a substantial nexus with the taxing state; (2) fairly apportioned; (3) nondiscriminatory; and (4) fairly related to the services provided by the state.

In *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979), this Court extended the application of the *Complete Auto* four-prong test to challenges under the Foreign Commerce Clause. Noting that when foreign commerce is involved "a more extensive

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[14] To date, Congress has limited its regulation of state income taxation to Pub.L. No. 86-272, which precludes states from imposing a tax on income attributable to mere solicitation within a state. 15 U.S.C. § 381 (1988). See *Wisconsin Dep't of Rev.* v. *William Wrigley, Jr., Co.*, No. 91-119, now pending on certiorari.

constitutional inquiry is required," this Court added two additional prongs to the *Complete Auto* test. They ask whether the tax (1) creates a substantial risk of international multiple taxation; and (2) prevents the federal government from speaking with one voice when regulating commercial relations with foreign governments. *Id.* at 446, 451. *See also Wardair, supra*, 477 U.S. at 8.

Petitioner's Commerce Clause challenge to the Iowa statute here in question arises solely under the "discrimination" prong of the six-part test.[15]

A. The Iowa Taxing Scheme Facially Discriminates Against Foreign Commerce.

Petitioner is a multinational enterprise that operates a unitary business throughout the United States and in various foreign countries. Among the sources of capital on which petitioner relies to conduct its business are dividends received from its foreign subsidiaries. During 1981, the year here at issue, petitioner received dividends from six foreign subsidiaries that conducted their respective business operations in five different countries. In that year, the flow of capital from those foreign subsidiaries to petitioner exceeded $8 million, net of foreign withholding taxes. Petitioner received no domestic subsidiary dividends in 1981.

Because petitioner conducts a portion of its unitary business in Iowa, it is subject to Iowa's Business Tax

[15] This issue was not considered by this Court in *Mobil, supra*. There, the taxpayer challenged the constitutionality of a Vermont statute that was virtually identical to the Iowa statute now under review, but on grounds not raised by petitioner here.

on Corporations. That tax is imposed on the portion of petitioner's total net income from its unitary business that is properly apportioned to Iowa.[16] The Iowa statute, read in conjunction with the appropriate incorporated provisions of the federal Internal Revenue Code, requires petitioner to include dividends received from its foreign subsidiaries (but not its domestic subsidiaries) in the calculation of its unitary business income subject to apportionment. The Iowa taxing scheme thus burdens the flow of capital from foreign subsidiaries without similarly burdening the flow of capital from domestic subsidiaries.[17]

This Court's decisions dating back over 100 years make it clear that imposing such a discriminatory burden on foreign commerce violates the Foreign Commerce Clause. In *Cook* v. *Commonwealth of Pennsylvania*, 97 U.S. 566 (1878), this Court considered the validity of a Pennsylvania statute that levied a tax on auctioneers, measured by the proceeds of items sold at auction. An exemption was provided for "gro-

[16] In *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267 (1978), this Court upheld the validity of Iowa's single factor apportionment formula.

[17] The fact that Iowa's statute facially discriminates in the composition of the tax base, rather than by imposing a discriminatory tax *per se*, cannot be of constitutional significance. A state discriminates against foreign commerce whether it taxes such commerce at a higher rate or includes in its tax base certain types of income when generated in foreign commerce but not when generated in domestic commerce. *Cf. Westinghouse Elec. Corp.* v. *Tully*, 466 U.S. 388, 404-405 (1984).

Nothing in *Shell Oil Co.* v. *Iowa Dep't of Revenue*, 488 U.S. 19 (1988), is inconsistent with this conclusion. *Shell* involved questions of extraterritoriality, not discrimination, in the composition of the Iowa tax base.

ceries, goods, wares, and merchandise of American growth or manufacture." *Id.* at 569.

This Court held that the Pennsylvania tax was a tax on the goods sold, and that its discriminatory nature caused it to violate both the Import-Export Clause and the Foreign Commerce Clause. Referring to its prior decision in *Welton v. Missouri*, 91 U.S. 275 (1876), which struck down a state statute that discriminated against goods produced in other states, this Court declared:

> The Congress of the United States is granted the power to regulate commerce with foreign nations in precisely the same language as it is that among the States. If a tax assessed by a State injuriously discriminating against the products of a State of the Union is forbidden by the Constitution, a similar tax against goods imported from a foreign State is equally forbidden.
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> * * *
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> In granting to Congress the right to regulate commerce with foreign nations and among the several States, and with the Indian Tribes, and in forbidding the States without the consent of that body to levy any tax on imports, the framers of the Constitution believed that they had sufficiently guarded against the dangers of any taxation by the States which would interfere with the freest interchange of commodities among the people of the different States, and by the people of the States with citizens and subjects of foreign governments.

Id. at 573-574. *Cook* v. *Pennsylvania* stands unmistakably for the proposition that individual States cannot single out foreign commerce for taxation without violating the Foreign Commerce Clause.

In *Hale* v. *Bimco Trading, Inc.*, 306 U.S. 375 (1939), this Court again struck down a statute that improperly discriminated against foreign commerce by exposing such commerce to burdens that domestic commerce was not required to bear. The statute at issue in *Hale* mandated the inspection of, and the payment of an inspection fee with respect to, cement imported into Florida from any foreign country. Those burdens were not imposed on cement produced in Florida or any other state. Acknowledging "discrimination in the incidence of an obviously onerous exaction as between foreign and domestic cement," *id.* at 379, this Court, citing *Cook* v. *Pennsylvania*, held that the Florida statute violated the Foreign Commerce Clause.

Like the statutes involved in *Cook* and *Hale*, the Iowa taxing statute on its face exposes foreign commerce to a burden to which domestic commerce is not exposed. As this Court held in *Armco Inc.* v. *Hardesty*, 467 U.S. 638 (1984), such a facially discriminatory statute must be struck down as unconstitional without further inquiry.[18]

B. The Court Below Upheld the Iowa Taxing Scheme By Applying an Erroneous Test.

The Iowa Supreme Court framed the test for determining impermissible discrimination against for-

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[18] *See also Tyler Pipe Indus. Inc.* v. *Washington Dep't of Rev.*, 483 U.S. 232 (1987). That *Armco* and *Tyler Pipe* involved interstate commerce rather than foreign commerce cannot affect this conclusion.

eign commerce as whether "Iowa businesses receive a commercial advantage over foreign commerce due to Iowa's taxing scheme." (Pet. App. 7a) In applying that test, the Iowa court apparently believed that it was required to adopt without modification the "local commercial advantage" test that this Court has applied in the interstate commerce context. *See, e.g., Bacchus Imports, Ltd.* v. *Dias*, 468 U.S. 263, 268 (1984). The court below held that "[b]ecause the Iowa tax does not differentiate between in-state or out-of-state taxpayers, no impermissible discrimination exists." (Pet. App. 7a-8a)

The Iowa court expressed genuine uncertainty as to whether it was applying the appropriate test. (Pet. App. 7a)[19] Its doubts were well-founded. This Court's decisions do not require a differentiation in the treatment of "in-state or out-of-state" *domestic* businesses

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[19] The only citation offered by the court below to support its application of the "local advantage" test in this foreign commerce case was a passage quoted out of context from Tatarowicz and Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 Vand. L. Rev. 879, 941 (1986). The passage quoted by the court was addressing a tax that discriminated against interstate commerce and *in favor of* foreign commerce. The commentators expressed quite a different view where, as is true in the instant case, the statute discriminates in favor of interstate commerce and *against* foreign commerce.

> It is also unclear whether a state tax provision can favor interstate commerce over foreign commerce. The additional protection afforded foreign commerce renders it unlikely that such a provision would be held constitutional.

Id. at 941 n.298.

in order to find that a statute impermissibly discriminates against *foreign* commerce.

As noted, the statute at issue in *Cook* v. *Pennsylvania, supra*, exempted all American goods, not merely goods produced in Pennsylvania. This Court did not require a showing that Pennsylvania goods enjoyed an advantage over other domestic goods, or even that Pennsylvania goods were being sold, before holding the statute unconstitutional. (The court below responded to this Court's holding in *Cook* by ignoring it.)

The statute at issue in *Hale* v. *Bimco Trading, Inc., supra*, exempted all domestic cement, not merely cement produced in Florida. While the legislative history suggested a desire to benefit the Florida cement industry, this Court did not require a showing that Florida cement enjoyed an advantage over other domestic cement before declaring the law invalid. *Hale* was identical to *Cook* in that regard. In both cases, this Court used the same analysis to reach the same result. (The court below chose to treat *Hale* as a "local advantage" case.)

The decisions in *Cook* and *Hale* reflect this Court's full recognition of the original purpose and thrust of the Foreign Commerce Clause. Both that Clause and the Import-Export Clause were directed in large part at curtailing the power of the coastal States to tax foreign commerce to the detriment of their sister States. As this Court observed in *Michelin Tire Corp.* v. *Wages*, 423 U.S. 276 (1976):

> One of the major defects of the Articles of Confederation, and a compelling reason for the calling of the Constitutional Convention

> of 1787, was the fact that the Articles essentially left the individual States free to burden commerce both among themselves and with foreign countries very much as they pleased.

Id. at 283.

Nothing in *Michelin* suggests that the Framers were motivated by complaints that the States were using their taxing powers for the benefit of local commerce. The strongest concerns manifested were directed at the unrestrained zeal of certain States in taxing foreign goods that were destined for neighboring States. *Michelin, supra,* at 283-286.[20]

This Court has acknowledged that both the Foreign Commerce Clause and the Import-Export Clause were aimed in part at preserving harmony among the States by precluding the imposition of taxes on goods merely passing through one State en route to another State.[21] Early case law that dealt with the discriminatory nature of state taxation tended to involve taxes

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[20] The extensive historical analysis undertaken in *Michelin,* while focused on the purposes of the Import-Export Clause, is directly relevant here because of the overlap between that Clause and the Foreign Commerce Clause. *See, e.g., Japan Line, supra,* at 449 n.14 ("The policies animating the Import-Export Clause and the Commerce Clause are much the same."); *Department of Rev.* v. *Association of Washington Stevedoring Cos.,* 435 U.S. 734, 754-755 (1978) (applying four-prong *Complete Auto* test to challenge under Import-Export Clause.)

[21] The other two objectives of both Clauses were to ensure that the federal government spoke with one voice in all matters involving foreign relations and that import duties would become the major source of federal revenue. *Michelin, supra,* at 285-286; *Japan Line, supra,* at 449 n.14.

on goods originating in sister states.[22] *Cook* v. *Pennsylvania* appears to have been the first case to address squarely the question of discrimination against foreign goods. *Cook* established that a specific showing of "local advantage" was not essential to a determination that a State had violated the Foreign Commerce Clause when it singled out foreign goods for taxation.[23]

Japan Line offers the most current guidance on this question. In discussing concerns of multiple taxation where foreign commerce is involved, this Court declared that a state tax "may subject foreign commerce 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids.' " *Id.* at 448 (brackets in

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[22] *E.g., Woodruff* v. *Parham,* 75 U.S. 123 (1869), and *Hinson* v. *Lott,* 75 U.S. 148 (1869), both of which upheld taxing statutes that were found to be nondiscriminatory because they applied to goods produced locally as well as goods produced in other States; *Welton* v. *Missouri,* 91 U.S. 275 (1876), which struck down a statute that taxed sellers of goods brought into Missouri from other states.

[23] *Cook* addressed a point left open in the landmark case of *Brown* v. *Maryland,* 25 U.S. 419 (1827). After striking down under both the Import-Export Clause and the Foreign Commerce Clause a Maryland license fee imposed on importers and sellers of goods in their imported state, Chief Justice Marshall concluded his analysis by stating:

> We do not mean to give any opinion on a tax discriminating between foreign and domestic articles.

Id. at 449. Chief Justice Marshall apparently did not consider the Maryland license fee in terms of its possible discriminatory effect, but only in terms of its effect on imports *qua* imports. See *Michelin, supra,* at 288 n. 7, discussing certain Import-Export Clause implications of *Brown* v. *Maryland.*

original), quoting from *Evco* v. *Jones*, 409 U.S. 91, 94 (1972), which in turn quoted from *J.D. Adams Mfg. Co.* v. *Storen*, 304 U.S. 307, 331 (1938), both of which involved "interstate commerce" issues. By replacing the original word "intrastate" used in *J.D. Adams Mfg. Co.* with the bracketed word "[domestic]," this Court clearly signalled in *Japan Line* that, at most, proper Foreign Commerce Clause analysis compares the effect of a challenged tax on foreign commerce with its effect on domestic commerce in general, not merely on local commerce.

Japan Line reflects what this Court previously observed in *Cook*—the Framers intended that the Foreign Commerce Clause protect against the dangers of any state taxation that might interfere with the "freest interchange" between domestic and foreign commercial interests. *Cook*, *supra*, at 573. Requiring a showing of "local advantage" fails to give full effect to the intended scope of that Clause.

Against this backdrop, there is little doubt that the facially discriminatory Iowa taxing scheme constitutes an impermissible attempt to regulate foreign commerce. Iowa seeks to tax capital transferred *into* this country in the form of dividends from foreign subsidiaries. It makes no attempt to tax capital transferred *within* this country in the form of dividends from domestic subsidiaries. The discrimination is obvious. To uphold the Iowa statute would be totally inconsistent with the intention of the Framers.

C. *New Energy* Provides No Support For Respondent.

Relying on *New Energy Co.* v. *Limbach*, 486 U.S. 269 (1988), respondent, in its Brief in Opposition, attempted to justify Iowa's discriminatory treatment of

foreign subsidiary dividends by arguing that its reason for such treatment is "justified by a valid factor unrelated to economic protectionism." (Br. Opp. 16-18, quoting *New Energy* at 274.) *New Energy* does not provide support for respondent's position here.

First, *New Energy* was unusual in its application of a regulatory discrimination analysis to a taxing statute. The reason for this Court's approach in that case seems clear. Ohio attempted to justify its discriminatory taxation of out-of-state ethanol on health grounds. This Court presumably felt compelled to apply its regulatory balancing test because the state had arguably exercised its police power indirectly through the taxing statute. In the instant case, however, Iowa does not attempt to justify its facially discriminatory taxation of dividends as an indirect exercise of its police power. It simply offers "convenience" as the purpose for its discrimination. Convenience, of course, has no relationship to the exercise of the state's police power. Thus, an application of the *New Energy* balancing test is not appropriate in these circumstances.

Moreover, even if the *New Energy* analysis were considered applicable, it would not sanction the discrimination here at issue. As this Court there explained, a discriminatory statute may survive constitutional challenge only if the state can show it "advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives." *New Energy*, at 278. "Convenience," the alleged local purpose here, can easily be served by excluding foreign subsidiary dividends from the Iowa tax base. Such an adjustment to the federal computation would require virtually no effort by taxpayers. It also would not reduce the alleged benefit Iowa finds

in relying primarily on the federal system in calculating net income subject to apportionment. Assuming, arguendo, that "convenience" is a "legitimate local purpose" in this context, its objectives can adequately be served by a reasonable nondiscriminatory alternative to the present system of dividend taxation.

New Energy thus does not support respondent's claim that Iowa's discriminatory taxing scheme is constitutionally permissible.

II. IOWA'S CLASSIFICATION OF DIVIDEND INCOME DENIES PETITIONER EQUAL PROTECTION BECAUSE IT IS NOT RATIONALLY RELATED TO A LEGITIMATE STATE PURPOSE.

This Court has not hesitated to invoke the Equal Protection Clause to reject attempts by a state to tax one class of taxpayers on a more onerous basis than another similarly situated class. *Williams* v. *Vermont*, 472 U.S. 14 (1985); *WHYY, Inc.* v. *Borough of Glassboro*, 393 U.S. 117 (1968); *Wheeling Steel Corp.* v. *Glander*, 337 U.S. 562, 572 (1949). Iowa's discriminatory classification can only survive an equal protection challenge if it is "rationally related to achievement of a legitimate state purpose." *Western & S. Life Ins. Co.* v. *State Bd. of Equalization*, 451 U.S. 648, 668 (1981).

A. Iowa's Classification Serves No Legitimate State Purpose.

As previously discussed, federal law excludes domestic subsidiary dividends from taxable income because their inclusion would result in U.S. double taxation of income in corporate solution. Federal law includes foreign subsidiary dividends in taxable income because the underlying income of foreign subsidiaries is not itself subject to U.S. tax. Federal law

does, however, allow a foreign tax credit to mitigate international double taxation.

The mere fact that the federal government treats domestic subsidiary dividends differently from foreign subsidiary dividends does not provide Iowa with a legitimate purpose for its discrimination. Action that is legitimate when taken at the federal level may become illegitimate when undertaken by a state. *Compare Mathews* v. *Diaz*, 426 U.S. 67 (1976) (alienage distinction in *federal* Medicare law does not violate equal protection) *with Graham* v. *Richardson*, 403 U.S. 365 (1971) (alien exclusion in *state* welfare law violates equal protection).

Unlike the federal system, the Iowa system clearly is not based on the avoidance of double taxation. Iowa excludes domestic subsidiary dividends from taxation even where the earnings from which they are paid are not subject to Iowa tax (*e.g.*, where a domestic subsidiary not taxable in Iowa pays a dividend to a parent company doing business in Iowa). In addition, Iowa offers no credit for foreign taxes paid with respect to foreign subsidiary dividends. Iowa's focus is not on double taxation at all, and its classification of dividends completely lacks a substantive tax policy justification.

In recognition of this fact, the Iowa Supreme Court based its Equal Protection conclusion on the ground that using federal "taxable income" as a basis for calculating Iowa "net income" was convenient for both the taxpayer and the State. According to the court below:

> "The taxpayer is permitted to merely lift the figures off the federal return and transfer

them to the Iowa franchise tax return." [quoting *First Nat'l Bank of Ottumwa* v. *Bair*, 252 N.W.2d 723, 726 (Iowa 1977)]

* * *

[T]he coupling of Iowa net income with the federal formula is convenient for the taxpayer, prevents the taxpayer from spending time and money on complex forms, provides a saving to the state, allows the state to rely on federal regulation and interpretation, and provides the state with an inexpensive and quick way of verifying the accuracy of taxpayers returns.

(Pet. App. 9a-10a)

Administrative convenience may be a legitimate reason for taxing two items differently when there is a meaningful difference in the nature of the items. For example, a state may tax out-of-state bank deposits of a local taxpayer at a higher rate than in-state bank deposits because it is more difficult and expensive to enforce collection of the tax on out-of-state deposits. *See Madden* v. *Kentucky*, 309 U.S. 83, 89-90 (1940).

Administrative convenience may also be a legitimate reason for taxing two taxpayers differently when there is a meaningful difference between the taxpayers. For example, a state may elect to tax employers with eight or more employees while exempting those with fewer than eight employees because the cost of measuring and administering the tax with respect to small employers may outweigh the revenue to be derived. *See Carmichael* v. *Southern Coal & Coke Co.*, 301 U.S. 495, 511 (1937).

Neither taxpayer nor administrative convenience, however, can be a legitimate reason for a classification where, as here, there is no meaningful difference in the nature of the items being taxed or in the taxpayers themselves. Allowing a state to claim "convenience" in order to justify the imposition of unequal burdens in such a case would make a mockery of the Equal Protection Clause.

It would no doubt be "convenient" for Iowa to tax all Delaware corporations doing business in Iowa by apportioning their "net income" as originally calculated for Delaware tax purposes: such corporations would not have to spend time and money preparing separate calculations on multiple forms, and the two states could reduce the cost of administering their tax systems and verifying the accuracy of tax returns by combining their audit efforts. But surely such separate treatment of Delaware corporations vis-a-vis other corporations doing business in Iowa would not be deemed to satisfy equal protection requirements merely because of the taxpayer and administrative convenience it would afford. If Iowa cannot, on grounds of convenience, treat the income of Delaware corporations differently from the income of non-Delaware corporations doing business in Iowa, why should it be allowed to treat domestic subsidiary dividends differently from foreign subsidiary dividends on the same ground?

B. Iowa's Taxing Scheme Is Not Rationally Related to a Purpose of Convenience.

Even if the goal of taxpayer and administrative convenience were a legitimate one in this context, Iowa's extensive modifications to federal "taxable income" for purposes of determining Iowa "net in-

come" undermine its claim that its taxing scheme is rationally related to that objective.

For the year 1981, Iowa's taxing statute required corporate taxpayers to make nine separate adjustments to their federal taxable income in order to determine their proper Iowa tax base. Iowa required taxpayers to: (1) subtract interest and dividends from federal securities; (2) add other interest and dividends exempt from federal tax; (3) adjust the basis used on the federal return for determining gain or loss on the sale of certain assets; (4) subtract 50 percent of net federal income taxes paid; (5) add certain amounts relating to depreciable assets shown on the federal return; (6) subtract targeted job credits granted on the federal return; (7) subtract certain alcohol fuel credits allowed on the federal return; (8) add certain amounts deducted on the federal return for sale-leaseback agreements; and (9) add the windfall profits tax determined on the federal return. Iowa Code § 422.35 (1983).[24] (Iowa now requires 14 adjustments to federal taxable income. Iowa Code § 422.35 (1990 & Supp. 1991).) In addition, as noted earlier, Iowa did not (and still does not) allow a recipient of foreign subsidiary dividends to claim a foreign tax credit, whether or not one is claimed for federal purposes. It does, however, adjust for the "gross up" amount if such a credit is claimed on the federal return.

[24] Iowa's first adjustment recognizes that "administrative convenience" cannot override other constitutional limitations. By requiring the subtraction of interest and dividends from federal securities, Iowa observes the doctrine of intergovernmental immunity, founded upon the "Borrowing" and "Supremacy" Clauses, *Society For Savings* v. *Bowers*, 349 U.S. 143, 144 (1955), citing, *Weston* v. *Charleston*, 27 U.S. 449 (1829), and codified by Congress, 31 U.S.C. § 3124 (1988), which limits a state's power to tax income from federal securities.

It is obvious from the fact and nature of Iowa's adjustments that something more is involved in preparing an Iowa return than having the taxpayer "merely lift the figures off the federal return." (Pet. App. 9a) The varied and complex adjustments required by Iowa undoubtedly cause taxpayers to spend time and money in tax preparation. They also undoubtedly require the state to incur particular costs in the administration of its system to verify the adjustments made. The Iowa taxing system is in reality something of a hodge-podge that is anything but convenient.

While Iowa relies on federal taxable income as the starting point for its tax base calculations, it makes adjustments to the federal system whenever and wherever its purposes are suited. In light of the multiplicity of adjustments that the state legislature requires and the simplicity of subtracting foreign subsidiary dividends from the tax base in order to eliminate the present discrimination, Iowa's decision to tax foreign subsidiary dividends but not domestic subsidiary dividends as part of its "selective" incorporation of federal figures must be seen as "wholly arbitrary" under the circumstances. *New Orleans* v. *Dukes*, 427 U.S. 297, 303-304 (1976).

In *Lehnhausen* v. *Lake Shore Auto Parts, Inc.*, 410 U.S. 356 (1973), this Court reiterated the dictum that in an Equal Protection dispute not involving fundamental rights, the burden was on the challenger "to negative every conceivable basis" for the challenged classification. *Id.* at 364. By altering the calculation of federal taxable income in numerous ways to ac-

commodate its own interests, Iowa has acted in a manner that is totally inconsistent with the one justification it has offered in support of the discrimination in question. As a result, the only "conceivable basis" for its classification of dividend income has clearly been "negatived" by Iowa itself.

CONCLUSION

For all of the foregoing reasons, the decision of the Supreme Court of Iowa should be reversed.

Respectfully submitted,

/s/ Jerome B. Libin
JEROME B. LIBIN
(Counsel of Record)
KATHRYN L. MOORE
HEATHER C. MALOY

SUTHERLAND, ASBILL & BRENNAN
1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
(202) 383-0100

Counsel for Petitioner

Of Counsel:

JOHN V. DONNELLY

BROWN, WINICK, GRAVES, DONNELLY, BASKERVILLE AND SCHOENEBAUM
1100 Two Ruan Center
601 Locust Street
Des Moines, Iowa 50309
(515) 283-2076

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APPENDIX

APPENDIX A

RULE 29.1 STATEMENT

The subsidiaries of petitioner other than wholly-owned subsidiaries are as follows:

464088 Ontario Ltd.
Abal Hermanos S.A.
AGF SP Inc.
Ajinomoto GF, Inc.
Artes Graficas Unidas S.A.
Australian Dried Fruit Agency
Bell Pack, Inc.
C.A. Tabacalera Nacional
Cafe Grand Mere
Cerveceria Nacional Dominicana C. Por A.
Ceylon Tobacco Company Limited
CIA Inversiones Puerto Plata S.A.
Cigarros La Tabacalera Mexicana S.A. de C.V.
Colombina General Foods S.A.
Comptoir de La Confiserie SNC
Confederation of European Community Cigarette Manufacturer's Ltd.
Constellation
Crippa e Berger Fonti Levissima
Dairy Industries Ltd.
Dairy Industries (Jamaica) Ltd.
Dong Mei Food Company Ltd.
Dong Suk Foods Corporation
Dong Suk Ginseng
Don Suk Oil & Fats Co. Inc.
E. Leon Jimenes C. Por A.
Egri Dohanygyar KFT
Fabrica de Cigarillos El Progresso S.A.
Fattorie Osella S.P.A.
Galas de Mexico S.A. de C.V.
General Foods de Colombia
Godfrey Phillips India, Limited

Grundtuck Sgemeinschaft Jacobs Suchard
Guangtong Food Company Ltd.
Hamni Bank
Hostess Frito-Lay
Industria Licorera Hispanoamericana S.A.
Industrias Del Tabaco Alimentos y Bebidas S.A.
International de Vinos, S.A.
International Pet Foods Ltd.
International Tobacco Company Limited
ION S.A.
Jacobs Suchard Budapest GMBH
Kibon S.A.
Korea First Advertising Co. Ltd.
Kotharigf Corp. Ltd.
Kotsiopouli Bros.
L.W. de Mexico S.A. de C.V.
LACTA S.A.
Massalin Particulares S.A.
Maxpax S.A.
Mendiola y Compania, S.A.
Negroni Holding 93
O'Refresko S.A.
Oscar Mayer Cp. Co. Ltd.
Philip Morris Espana S.A.
Philip Morris Sabanci Sigara ve Tutunculuk Sanayi ve Ticaret A.S.
Pietro Negroni Deutschland GmGH
Pietro Negroni France S.A.
Pietro Negroni S.R.L.
Premier Foods Corp.
Prima Meat Packers, Ltd.
Premier Tobacco Industries Limited
Proveedora Ecuatoriana S.A.
Pusan Insurance
Rothman, Benson & Hedges Inc.
Rothman's (UK) Limited
Sam Kwang Glass Co.

SICMA
Sociedad Agricola Comercial Ecuatoriana
Societa di Decaffeinizzazione
Societe Immobilere du 283 Rue de Rosny
Sorcal Comercia di Alimenticos LTDA
Sorvetes e Produtos Alimenticos do Mordests S.A.
Sparkle CP Ltd.
Tabacalera Andina S.A.
Tabacalera Centroamericana S.A.
Tabacalera Costarricense, S.A.
Tabacalera de El Salvador S.A. de C.V.
Tabacalera Nacional, S.A.
Tabacos Norte S.A.
Tabamark S.A.
Tabamax S.A.
Taloca y CIA LtdA
TianMei Food Company Ltd.
Vincenzi Biscotti S.P.A.
Yoplait Italia S.P.A.

APPENDIX B

61. Gross Income Defined.

(a) General Definition

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

78. Dividends Received from Certain Foreign Corporations by Domestic Corporations Choosing Foreign Tax Credit.

If a domestic corporation chooses to have the benefits of subpart A of part III of subchapter N (relating to for-

eign tax credit) for any taxable year, an amount equal to the taxes deemed to be paid by such corporation under section 902(a) (relating to credit for corporate stockholder in foreign corporation) or under section 960(a)(1) (relating to taxes paid by foreign corporation) for such taxable year shall be treated for purposes of this title (other than section 245) as a dividend received by such domestic corporation from the foreign corporation.

164. Taxes.

(a) General Rule

Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

* * *

(3) State and local, and foreign, income, or profits, and excess taxes.

* * *

(b) Definitions of special rules. For purposes of this section—

* * *

(3) Foreign Taxes. A foreign tax includes only a tax imposed by authority of a foreign country.

* * *

APPENDIX C

422.35 Net income of corporation - how computed.

The term **"net income"** means the taxable income before the net operating loss deduction, as properly computed for federal income tax purposes under the Internal Revenue Code, with the following adjustments:

1. Subtract interest and dividends from federal securities.

2. Add interest and dividends from foreign securities, from securities of state and other political subdivisions, and from regulated investment companies exempt from federal income tax under the Internal Revenue Code.

3. Where the net income includes capital gains or losses, or gains or losses from property other than capital assets, and such gains or losses have been determined by using a basis established prior to January 1, 1934, an adjustment may be made, under rules and regulations prescribed by the director, to reflect the difference resulting from the use of basis of cost or January 1, 1934, fair market value, less depreciation allowed or allowable, whichever is higher. Provided that the basis shall be fair market value as of January 1, 1955, less depreciation allowed or allowable, in the case of property acquired prior to that date if use of a prior basis is declared to be invalid.

4. Subtract fifty percent of the federal income taxes paid or accrued, as the case may be, during the tax year, adjusted by any federal income tax refunds; and add the Iowa income tax deducted in computing said taxable income.

5. Subtract the amount of the jobs tax credit allowable for the tax year under section 51 of the Internal Revenue Code to the extent that the credit increased federal taxable income.

6. If the taxpayer is a small business corporation, subtract an amount equal to sixty-five percent of the wages paid to individuals, but not to exceed twenty thousand dollars per individual, named in paragraphs "a", "b" and "c" who were hired for the first time by the taxpayer during the tax year for work done in this state:

a. A handicapped individual domiciled in this state at the time of the hiring who meets any of the following conditions:

(1) Has a physical or mental impairment which substantially limits one or more major life activities.

(2) Has a record of that impairment.

(3) Is regarded as having that impairment.

b. An individual domiciled in this state at the time of the hiring who meets any of the following conditions:

(1) Has been convicted of a felony in this or any other state or the District of Columbia.

(2) Is on parole pursuant to chapter 906.

(3) Is on probation pursuant to chapter 907, for an offense other than a simple misdemeanor.

(4) Is in a work release program pursuant to chapter 246, division IX.

c. An individual, whether or not domiciled in this state at the time of the hiring, who is on parole or probation and to whom the interstate probation and parole compact under section 907A.1 applies.

This deduction is allowed for the wages paid to the individuals successfully completing a probationary period named in paragraphs "a", "b", and "c" during the twelve months following the date of first employment by the taxpayer and shall be deducted in the tax years when paid.

For purposes of this subsection, "physical or mental impairment" means any physiological disorder or condition, cosmetic disfigurement, or anatomical loss affecting one or more of the body systems or any mental or psychological disorder, including mental retardation, organic brain syndrome, emotional or mental illness and specific learning disabilities.

6A. If the taxpayer is a business corporation and does not qualify for the adjustment under section 422.35, subsection 6, subtract an amount equal to sixty-five percent of the wages paid to individuals, but shall not exceed twenty thousand dollars per individual, named in paragraphs "a" and "b" who were hired for the first time by the taxpayer during the tax year for work done in this state:

a. An individual domiciled in this state at the time of the hiring who meets any of the following conditions:

(1) Has been convicted of a felony in this or any other state or the District of Columbia.

(2) Is on parole pursuant to chapter 906.

(3) Is on probation pursuant to chapter 907, for an offense other than a simple misdemeanor.

(4) Is in work release program pursuant to chapter 246, division IX.

b. An individual, whether or not domiciled in this state at the time of the hiring, who is on parole or probation and to whom the interstate probation and parole compact under section 907A.1 applies.

This deduction is allowed for the wages paid to the individuals successfully completing a probationary period named in paragraphs "a" and "b" during the twelve months following the date of first employment by the taxpayer and shall be deducted in the tax years when paid.

The department shall develop and distribute information concerning the deduction available for businesses employing persons named in paragraphs "a" and "b".

7. Subtract the amount of the alcohol fuel credit allowable for the tax year under section 40 of the Internal Revenue Code to the extent that the credit increased federal taxable income.

8. Add the amounts deducted and subtract the amounts included in income as a result of the treatment provided sale-leaseback agreements under section 168(f)(8) of the Internal Revenue Code for property placed in service by the transferee prior to January 1, 1986 to the extent that the amounts deducted and the amounts included in income are not otherwise deductible or included in income under the other provisions of the Internal Revenue Code as amended to and including December 31, 1985. Entitlement to depreciation on any property involved in a sale-leaseback agreement which is placed in service by the transferee prior to January 1, 1986 shall be determined under the Internal Revenue Code as amended to and including December 31, 1985, excluding section 168(f)(8) in making the determination.

9. Add the amount of windfall profits tax deducted under section 164(a) of the Internal Revenue Code.

10. Add the percentage depletion amount determined with respect to an oil, gas, or geothermal well using methods in section 613 of the Internal Revenue Code that is

in excess of the cost depletion amount determined under section 611 of the Internal Revenue Code.

11. If after applying all of the adjustments provided for in this section and the allocation and apportionment provisions of section 422.33, the Iowa taxable income results in a net operating loss, such net operating loss shall be deducted as follows:

a. The Iowa net operating loss shall be carried back three taxable years or to the taxable year in which the corporation first commenced doing business in this state, whichever is later.

b. The Iowa net operating loss remaining after being carried back as required in paragraph "a" of this subsection or if not required to be carried back shall be carried forward fifteen taxable years.

c. If the election under section 172(b)(3)(C) of the Internal Revenue Code is made, the Iowa net operating loss shall be carried forward fifteen taxable years.

d. No portion of a net operating loss which was sustained from that portion of the trade or business carried on outside the state of Iowa shall be deducted.

e. The limitations on net operating loss carryback and carryforward under sections 172(b)(1)(M) and 172(m) of the Internal Revenue Code shall apply.

Provided, however, that a corporation affected by the allocation provisions of section 422.33 shall be permitted to deduct only such portion of the deductions for net operating loss and federal income taxes as is fairly and equitably allocable to Iowa, under rules prescribed by the director.

12. Subtract the loss on the sale or exchange of a share of a regulated investment company held for six months or

less to the extent the loss was disallowed under section 852(b)(4)(B) of the Internal Revenue Code.

13. Subtract the interest earned from bonds and notes issued by the agricultural development authority as provided in section 175.17, subsection 10.

14. Add the expenses otherwise deductible under section 162(a) of the Internal Revenue Code which were incurred by a corporation with respect to expenditures made at, or payments made to, a club which restricts membership or the use of its services or facilities on the basis of age, sex, marital status, race, religion, color, ancestry or national origin.

A club described in this subsection holding an alcoholic beverage license pursuant to chapter 123 shall provide on each receipt furnished to a taxpayer a printed statement as follows: "The expenditures covered by this receipt are nondeductible for state income tax purposes."

For the purposes of this subsection, a club means any nonprofit corporation or association of individuals, which is the owner, lessee, or occupant of a permanent building or part of a building, membership in which entails the prepayment of regular dues, and which is not operated for a profit other than such profits as would accrue to the entire membership.